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IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, INC., AN ARIZONA CORPORATION, FOR AUTHORITY TO IMPLEMENT ARSENIC COST RECOVERY MECHANISMS FOR ITS AGUA FRIA WATER, SUN CITY WEST WATER, HAVASU WATER, AND TUBAC WATER DISTRICTS	DOCKET NO. W-01303A-05-0280
IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, INC., AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES BASED THEREON FOR UTILITY SERVICE BY ITS SUN CITY WEST WATER AND WASTEWATER DISTRICTS.	DOCKET NO. WS-01303A-02-0867
IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, INC., AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES BASED THEREON FOR UTILITY SERVICE BY ITS MOHAVE WATER DISTRICT AND ITS HAVASU WATER DISTRICT.	DOCKET NO. WS-01303A-02-0869 **ARIZONA-AMERICAN WATER COMPANY'S COMPLIANCE FILING OF EQUITY PLAN**

IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, INC., AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES BASED THEREON FOR UTILITY SERVICE BY ITS ANTHEM WATER DISTRICT, ITS AGUA FRIA WATER DISTRICT, AND ITS ANTHEM/AGUA FRIA WASTEWATER DISTRICT.	DOCKET NO. WS-01303A-02-0870

ARIZONA-AMERICAN WATER COMPANY'S COMPLIANCE FILING OF EQUITY PLAN

Commission Decision No. 68310 in the above-captioned dockets ordered Arizona-American Water Company ("Arizona-American" or the "Company") to "file a plan with Docket Control by December 31, 2005, that describes how Arizona-American expects to attain and maintain a capital structure (equity, long-term debt and short-term debt) with equity representing between 40 and 60 percent of total capital." This filing is submitted in compliance with that Decision.

The Company shares the Commission's goal of attaining and maintaining at least a 40% equity ratio and, hence the Commission's and Arizona-American's interests are largely aligned on this issue.

The Company's specific target is to reach and maintain an equity ratio of 40% (or somewhat higher) before the end of Arizona-American's current business planning period, December 31, 2010. The Company will likely temporarily reach 40% prior to 2010, but it will have difficulty maintaining that ratio until 2009, given known upcoming capital expenses, customer refunds, and regulatory lag associated with timing of capital expenses and rate cases.

The Company will be unable to reach an equity ratio of 50% or higher during this period and is unlikely to exceed 45%.

As of November 30, 2005, the Company's capital structure was 34.1% equity ($115.3 million), 57.5% long-term debt ($194.3 million) and 8.4% short-term debt ($28.3 million).

Financial Variables. Four financial variables directly influence Arizona-American's equity ratio:

1. Debt Financings. (Issuing debt decreases the equity ratio.) Arizona-American must obtain new debt to support its significant capital plan and borrowed $25 million in late 2004 to fund its new arsenic facilities. The Company has approximately $159 million in outstanding debt maturing November 2006 that it must refinance. The Company may also have other refinancing in 2006 as well as $15 million in new debt associated with new capital expenses.
2. Earnings. (Greater earnings support an increased equity ratio.) However, as discussed below, there are a number of constraints on Arizona-American's ability to generate earnings – resolution of which is at the core of the Company's plan.
3. Dividends versus Retaining Earnings. (Paying dividends decreases retained earnings and reduces the equity ratio.) Arizona-American has not paid a dividend since 2003 and does not expect to pay a dividend until it reaches / maintains a 40% equity ratio. Commission conditions earlier placed upon the Company require cessation of dividends upon a 35% equity ratio and an equity infusion upon a 30% equity ratio.
4. Equity Infusions. (Infusing equity raises the equity ratio). Company management is seeking approval in December 2005 from the Arizona American Water and American Water Works Boards of Directors for an equity infusion of up to $35 million in 2006.

Since approval of both Boards is necessary, the Company does not fully control the outcome of this request. Please note that Arizona-American faces significant competition with regulated affiliates in other jurisdictions whose rate-setting methodologies are presently more favorable. Arizona-American's allowed return on equity is currently the lowest among the 23 states in which American Water and its regulated affiliates operate. If approved, the Company expects to use this equity infusion to retire short-term debt. The Company does not believe that Commission approval for an equity infusion is required. Therefore, unless the Company learns otherwise, it will not be seeking Commission approval for the 2006 equity infusion.

Earnings Constraints. There are several constraints on Arizona-American's ability to increase earnings and improve its equity ratio:

- Enormous capital expenses required to serve our customers over the five-year planning horizon relative to existing rate base;
- Regulatory lag, which often delays Arizona-American's ability to earn on sunk capital;
- Legacy issues resulting from Arizona-American's acquisition of Citizens Utilities' water districts;
- Present rates set too low for Arizona-American to earn its authorized return during the period rates were / are in effect; and
- An existing three-year rate filing moratorium (expires January 2006), which constrained Arizona-American's ability to rectify under-earnings during the moratorium period.

For these and other reasons, Arizona-American can only make slow and uneven progress towards reaching and maintaining at least a 40% equity ratio. The first step is for Arizona-American to halt the immediate decline in its equity ratio.

EQUITY PLAN.

Given these factors, Arizona-American's proposed equity plan follows:

1. **ACRM and Fire Flow Implementation**. To prevent equity erosion, Arizona American must timely implement ACRM surcharges, hook-up fees, and fire-flow surcharges, and their subsequent Step rate increases in Sun City West, Agua Fria, Havasu, and Paradise Valley water districts.

2. **New Rate Cases**. To improve earnings and increase the equity ratio Arizona-American plans to file a series of new rate cases starting on or after January 12, 2006 (as the existing 3-year rate moratorium expires on January 11, 2006). Arizona-American has tentatively scheduled filing the following rates cases:

District	Filing Date:
Mohave - Water and Wastewater	January 2006
Anthem - Water	April 2006
Sun City - Wastewater	April 2006
Sun City West - Wastewater	April 2006
Agua Fria - Water	April 2007
Sun City - Water	April 2007
Sun City West - Water	April 2007
Tubac - Water	April 2007
Havasu - Water	April 2007
Anthem / Agua Fria - Wastewater	April 2007

With the exception of Paradise Valley, for which pending requests include both ACRM and public safety surcharges, virtually all these districts should repeat this filing cycle two years later (April 2008 and April 2009) due to planned capital expenses. This schedule is dynamic and will be updated periodically as events emerge and conditions dictate.

Arizona American will continue to hire qualified Rate Department personnel when it can to both support this currently-planned magnitude of rate case filings, and manage regulatory expenses. We will periodically present to Commission Staff Arizona-American's five-year capital-expenditure plan for informational and planning purposes.

3. **Hypothetical Capital Structures**. To help improve equity ratios, each of these upcoming rate cases will be based on a hypothetical capital structure, which assumes a 40% or greater equity ratio, even though the actual equity ratio will be less. The Commission has previously approved hypothetical capital structures for Southwest Gas and Tucson Electric Power, for the explicit purpose of improving actual equity ratios over time.

4. **Improved Returns on Equity**. As mentioned above, a significant challenge to attracting equity investment for Arizona-American is that the Commission's allowed returns on equity are the lowest allowed by any Commission in the 23 states where Arizona-American and its regulated affiliates operate. Arizona-American intends to continue to press the case for higher equity returns in every available forum.

5. **Rate Base for Citizens Plant**. Consistent with Decision No. 63584, in future rate cases for all former Citizens districts, rate base will be increased based on earlier approved rate treatment of advances in aid of construction and contributions in aid of construction retained by Citizens. Any acceleration of the amortization of these advances and contributions would contribute to the Company's equity plan. In the upcoming Mohave rate cases, consistent with Decision No. 63584, the Company will request amortization through the period January 2007, the date new rates are proposed to be in effect.

6. **Recovery of Citizens Acquisition Premium**. Arizona-American will request recovery in future rate cases of portions of the Citizens acquisition premium in those districts where it can demonstrate it meets the Commission's threshold net benefits standard.

7. **Reduced Capital Investment and Improved Operating Efficiency**. Arizona-American will continue its increased emphasis on reducing future capital expenses and on improving efficiency. As an initial step, any project categorized as "discretionary" has been removed from the capital plan unless accompanied by an explicit and viable regulatory-recovery plan. For example, the Paradise Valley fire flow-improvements remain in the plan as Arizona-American believes its pending request for a Public Safety surcharge is viable as evidenced by express community support and the Commission's recent approval (Decision No. 68303) of a deferral of depreciation and post in-service AFUDC on nearly $3 million of fire-flow investment now in service in Paradise Valley. By contrast, the Sun City fire flow project has been removed from the Company's capital plan because of the lack of community support for recovery of the costs of this project.

Arizona-American's total net capital expense plan, approved November 2005, for the period 2006 through 2010 is still substantial - $206 million. The Company will continue to examine the criteria for each project in the plan with an eye towards further reductions.

8. **Approval of White Tanks Water Capital Lease**. As part of capital expense reviews, Arizona-American learned it could not obtain corporate financing for the proposed White Tanks Regional Treatment Plant to be located in its Agua Fria district. As a result, Arizona-American has filed a request at the Commission for a series of approvals supporting a capital lease with Maricopa Water District for a regional facility that MWD will build and own. Commission approval of this request will support improvement in the Company's equity ratio by reducing regulatory lag.

9. **Reducing Advanced Plant and Associated Depreciation Expense**. Large portions of utility plant are funded by developer advances. Initially, this plant is considered to be

an advance in aid of construction, with no return on the advanced investment, but subject to depreciation. Over time, a portion of the cost of this plant is refunded to developers, at which time the plant is added to rate base. Any portion of a plant not refunded is transferred to a contribution account. At that time, the depreciation expense ceases on transferred balances and the previous cumulative depreciation is reversed.

In a rapidly growing area like Arizona-American's Agua Fria District, the annual depreciation expense on plant that will ultimately be classified as contributed plant significantly depresses reported earnings under GAAP. The Company estimates that between 50% to 75% of all advanced plant eventually becomes contributed plant. We propose to jointly evaluate this issue with Staff and determine whether an accounting order could help reduce depreciation expense (and the rates needed to recover this expense) and boost earnings.

10. **Treatment of Anthem Refunds**. Arizona-American forecasts refunding over $30 million in advances to Del Webb in its Anthem water and waste water districts in July 2007. The rate case the Company will file for the water district in April 2006 will provide the Commission creative and well supported proposals to proactively address this issue. Given the large magnitude of these future refunds, the Company's equity ratio will likely decline temporarily upon making them.

11. **Tubac Arsenic Remediation**. Arizona-American will endeavor to timely resolve the Tubac arsenic issue in a manner acceptable to the community and consistent with the revised compliance deadline of December 2007. However, to date the Company has invested $300,000 for vessels to support a central arsenic treatment facility. This prudent investment must be recovered to prevent further equity erosion. Arizona-American is open to creative solutions to minimize rate shock in Tubac in upcoming filings.

Conclusion

Arizona-American's plan is to reach and maintain, and perhaps somewhat exceed a 40% equity ratio by December 31, 2010. Arizona-American believes that it can ultimately achieve and maintain this 40% equity ratio. This will require Commission support, although we will not be asking for anything inconsistent with Commission precedent. To that end, the Company will be asking the Commission for a number of specific approvals that are needed to reach our shared goal of at least a 40% equity ratio.

As the above discussion illustrates, Arizona-American's first priority is to halt the existing erosion of equity caused by poor earnings by successfully implementing the ACRM and Paradise Valley rate increases and by filing new rate cases.

Progress towards maintaining a 40% equity ratio in 2006 through 2008 will be difficult because of known upcoming events, such as the $30 million advance refund in Anthem. Hence, while Arizona-American may temporarily reach a 40% equity ratio in 2006, it will be challenging to maintain that ratio in 2007 and 2008.

RESPECTFULLY SUBMITTED on November 30, 2005.

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